Defining and achieving good governance

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ABSTRACT

The research question for this paper is to identify how some widely accepted governance practices are not necessarily consistent with the objectives of good governance. One reason is that there is little agreement as to what are the objectives of generic good governance, be it in the public, private or non-profit sectors. The objective of good governance suggested for all sectors in this paper is the ability of an organization to further its purpose for its existence without imposing costs, harms and risks on society while acting equitably and ethically. In this way Corporate Social Responsibilities (CSR) become integrated into corporate governance while minimizing the extent, cost and need for government laws, regulations, regulators, legal actions and codes. However, many laws, regulations and codes accepted, promoted and even imposed by some regulators and governance-rating agencies include unethical counter productive conflicts of interests. Examples are identified with suggestions on how corporate constitutions could be amended to remove and/or ethically manage commonly accepted problems on a creditable basis by separating governance powers from management. A separation of powers facilitates stakeholder engagement to obtain feedback and correction on any costs, harms and risks introduced by the organization while obtaining intelligence for achieving operating benefits with good governance. Because unethical counter productive practices are so widely accepted by regulators and practitioners, this paper concludes that the involvement of lay lawmakers is required to provide the leadership for achieving good governance.

Key words: Conflicts**,** Co-regulation, CSR, Ethics, Self-governance.

JEL Classifications: B41, D21, D22, D63, G30, K12, K22, K23, L14, L20, L50, M14

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1. Introduction

The research question for this paper is to identify how some widely accepted governance practices are not necessarily consistent with the objectives of good governance. One reason is that there is little agreement as to what are the objectives of generic good governance, be it in the public, private or non-profit sectors. The objective of good governance suggested for all sectors in this paper is the ability of an organization to further its purpose for its existence without imposing costs, harms and risks on society while acting equitably and ethically. In this way Corporate Social Responsibilities (CSR) become integrated into corporate governance while minimizing the extent, cost and need for government laws, regulations, regulators, legal actions and codes (Turnbull 2014d).

However, many laws, regulations and codes accepted, promoted and even imposed by some regulators and governance-rating agencies include unethical counter productive conflicts of interests. Examples are identified with suggestions on how corporate constitutions could be amended to remove and/or ethically manage commonly accepted problems on a creditable basis by separating governance powers from management. A separation of powers facilitates stakeholder engagement to obtain feedback and correction on any costs, harms and risks introduced by the organization while obtaining intelligence for achieving operating benefits with good governance (Turnbull 2014b).

A fundamental problem is that regulators, governance rating agencies and experts who formulate governance codes have not articulated the objectives of generic good governance. Without an objective of where you want to be it does not matter where you head. As a result practices have been introduced that are assumed to promote good governance are neither supported by theory or compelling empirical evidence. On the other hand empirical evidence, common sense or the "science of governance" (Turnbull 2002b; 2008a; 2012) provides evidence why many current practices promoted as good governance have been the cause of unethical behavior, fraud, financial losses and firm failures.

Good governance described in this paper requires organizations to further their self-governance (Turnbull 2014a). Self-governance is ubiquitous in nature to allow creatures with little intelligence to reproduce in dynamic, complex unknowable environments. This paper describes how the laws of nature can be used to design the constitutions of organizations to follow the compelling success of simple creatures (Turnbull 2007; 2013c; 2014d).

However, the theory and practices of self-regulation is poorly recognized by social scientists including economists and lawyers who populate regulatory authorities and advise legislators. Legislators with knowledge of the science of control and communication, described as 'cybernetics' (Weiner 1948), or those with common sense are required to become involved to provide direction and leadership for furthering the common good by reforming corporate governance practices. The involvement of such individuals is assumed to be required because unethical counter productive practices have become so widely accepted by governance experts, rating agencies and entrenched in codes and even laws (Romano 2004).

Governance is fundamentally concerned about the exercise of power. But as noted in Lord Acton's dictum: "All power, corrupts and absolute power corrupts absolutely". The solution to the corruption of absolute power is a division of power to introduce checks and balances. Modern nation states typically introduce a division of power in their constitutions. However, few democracies require these principles to also be embedded into the constitutions of organizations be they in the public, private or non-profit sectors.

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To provide a focus for analysis this paper limits its discussion to the constitutional architecture of Publicly Traded Corporations (PTCs). Reform of public sector organizations is considered in Turnbull (1994; 1995) and non-profit organisations in Turnbull (2013b).

However, firms that are not PTCs need to be considered to provide evidence on how a separation of powers into two or more boards can provide competitive advantages. The term "Compound Board" will be used to describe: 'Two or more control centres, whether or not they are required by law, the constitution of the firm or are created by relationships external to the firm' (Turnbull 2000c, p. 27). Compound boards create 'network governance' (Turnbull 2000c, p. 76).

A global survey of stakeholder-controlled firms indicated that without exception, network governance was a condition for their ability to survive and thrive over generations of managers (Bernstein 1980). The existence of network-governed firms in many jurisdictions around the world provides evidence that no changes in law are required to introduce compound boards. High profile examples that possess over a hundred boards are the John Lewis Partnership in the UK, the Mondragón Corporation Cooperativa (MCC) in Spain and VISA Inc in the US from its formation in 1970 until it became a PLC in 2008.

In some jurisdictions, PLCs may be required to possess three of more boards (Analytica 1992). These "control centres" could include a Supervisory and an Audit Board elected by shareholders, a Works Council elected by employees, and an Executive Board appointed by the Supervisory Board. As a major shareholder is a 'control centre' of a firm and is 'created by relationships external to the firm' they become part of a compound board. La Porta, de Silanes & Shleifer (1999) found that 'relatively few firms' around the world did not have a major shareholder. The surprising result is that the phenomenon of compound boards is a global norm rather than an exception.

Not surprising is how suppliers of finance form a compound board as a condition of their providing funds. Venture Capitalists (VCs) typically require a shareholder agreement to transfer a number of governance power to them like the appointment and remuneration of directors, appointment and control of the auditor, strategic direction of the business including major capital investment, the payment of dividends, etc. Similar requirements are introduced by Leverage Buyout Organisations (LBOs) that Jensen (1993, p. 869) states represent 'a proven model of governance structure'. Loan agreements with bankers also introduce, but to a lesser degree, the sharing of power to create a compound board.

Major shareholders can act in a similar way to a supervisory board that appoints the executive board and auditor, determines the remuneration of both, and the strategic direction of the firm. However, English-speaking scholars have under-researched the phenomenon of multiple boards because it is considered to be a feature restricted to Europe.

Research has also been limited because a methodology for analyzing complex organizational forms is not well known. The methodology described as "Transaction Byte Analysis" (TBA) subsumes "Transaction Cost Economics" (TCE) developed by Williamson (1985). This is achieved by replacing the social construct of cost in TCE that is used as the unit of analysis with perturbations in nature described as 'bytes' (Turnbull 2000c, Table 7.1). As a result the operating and/or competitive advantages of compound boards has been little understood. Besides introducing checks and balances, network governance also introduces the decomposition of decision-making labor to improve the management of complexity. TBA provides a basis to explain what Clarke (2012) describes as the 'Recurring crises in Anglo-American Corporate Governance'.

Evidence of a systemic deficiency in Anglophone corporate governance is that "one company in two in the S&P 500 index of America's most valuable listed firms has had a big activist fund on its share register" (*The Economis*t 2015: 9). *The Economist* goes on to say that: 'activists fill a governance void that afflicts today's public companies'. Private equity funds and activist shareholders have invested over $100 billion to fill the void created by directors obtaining excessive powers not subject to meaningful review. This indicates how significant wealth could be added to the economy by the checks and balances introduced by network governance. Network governance would also introduce additional benefits by reducing the cost regulation discussed later.

Compound boards create a more economic, effective, efficient, timely and sensitive way to systemically fill the governance void with counter balancing influences. Network governance replaces the expensive and problematic competition for corporate control through stock markets with competition for power within the firm as described by writers like Bernstein (1978), Dallas (1997), Guthrie & Turnbull (1995), Jensen (1993), Hatherly (1995), Pound (1992; 1993a,b), Tricker (1980) and Turnbull (2000a,b,c; 2002a; 2013a,b,c; 2014a,b,c,d,e).

Financial institutions have provided the focus of the crises in Anglo-American corporate governance. It is these large systemically important financial institutions in the UK and the US that lack a major shareholder to provide oversight to introduce checks and balances. However, regulators seem blind to the problem of PLCs directors possessing absolute power to corrupt themselves and their business with serious harms imposed on the economy both locally and internationally. It would seem that regulators either lack the common sense of Lord Acton for the need to avoid concentrated power to mitigate corporate excesses, hubris, mistakes, fraud, unethical, or reckless behavior. One is forced to conclude that UK and US regulators have allowed their common sense to be overwhelmed by a belief that compliance to so called "good" corporate governance practices provides adequate safeguards.

It is for this reason that this paper recommends that the common sense of legislators be involved to force reform of current views of so called "good governance" in English speaking jurisdictions. Evidence is provided below that compliance to so-called "good governance" practices could well contribute to, rather than inhibit, corporate excesses, hubris, mistakes, fraud, unethical, or reckless behavior.

Economists Shleifer & Vishny (1997, p.2) defined corporate governance as 'the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment'. This statement is only relevant when the 'suppliers of finance' cited above require the sharing of power. The Shleifer & Vishny definition is not appropriate for financial institutions or PLCs generally when they become self-financing. As outlined in the next section the Shleifer & Vishny view is not supported by history of how current corporate governance practices evolved.

The third section reviews systemic director conflicts. Defining good governance and its competitive advantages are considered in the fourth section. Some of the natural laws of governance are outlined in section five followed by concluding remarks.

2. How did "good governance" practices become toxic?

This section reviews the evolution of corporate governance over recent centuries. It reveals how some practices that were developed to further private interests in the US or the UK were exchanged between jurisdictions to produce unintended negative consequences. Company directors and regulators initiated the problems, not 'suppliers of finance'.

One result is that corporate governance laws, regulations and codes failed to prevent the Global Financial Crisis of 2008. The US Government *Financial Crisis Inquiry Report* (FCIR

2011, p. xviii) concluded 'dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis'. Yet the 57 US banking institutions that required government assistance were more compliant with governance standards than other firms (Adams 2012). The UK Parliamentary Commission into Banking Standards Report (PCBSR 2013, p. 142) reported that the regulator 'was not so much the dog that did not bark as a dog barking up the wrong tree'. The inconvenient truth is that many practices accepted or enforced by regulators create toxic problems - rather than providing solutions.

It is inconvenient because it undermines many powerful reputations[1]. It also undermines much of the lucrative and extensive corporate governance compliance industry developed since the Cadbury report of 1992 as reported by Rose (2006).

The Cadbury recommendations promoted conflicted unethical relationships between directors and auditors that were identified two years earlier in a House of Lords judgment (Caparo 1990)[2]. The conflicts arose from Cadbury recommending the US practice of forming audit committees of directors instead of *shareholders*. US audit committees developed in the 1920s when stock exchanges did not even require firms to publish a balance sheet (O'Connor 2004, p. 40). US audit committees were formed to protect directors not investors (Guthrie & Turnbull 1995; Turnbull 2008b).

In the 1920s directors became personally liable for corporate liabilities if management did not use the cash obtained from lenders in ways approved by the lender. This led directors to hire a public accountant to check if management had used borrowed funds according to the loan agreement. The task was much simpler than auditing company accounts required today.

In the Caparo case, Lord Justice Oliver stated that the purpose of an external auditor was:

> …to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided (Caparo 1990, p. 17).

The Caparo case determined that UK audits were not prepared for investors but for members of a company to carry out their *governance* functions. Members of UK companies may have their liabilities limited by guarantee or by shares. However, in the US audits are not undertaken for shareholders but for *investor*s. When the SEC was established in 1933 its initial concerns were limited to the issue of *new* shares across state borders. Quite reasonably the US followed the 1929 UK prospectus practice for *new* issues of shares where the auditor is appointed by the directors and reports to the directors (O'Connor 2004, p. 51).

However, the statutory auditor arrangements in the UK, Australia and some other former colonies are quire different. The auditor is appointed by shareholders to report to shareholders – not the directors as in the US. Unfortunately the SEC Act of 1934 for *existing* shareholders inappropriately followed the UK practice for *new* share issues. As all four leading global audit firms are based in the US they have inappropriately insinuated the toxic US practice on the rest of the world. It is toxic because auditor becomes a paid agent of directors whose accounts he or she is judging. This unethical relationship creates a conflict for both the judge and those being judged a discussed below citing: Bazerman, Morgan & Loewenstein (1997); Caparo (1990, p. 11); Hatherly (1995); Hayward (2003); O'Connor (2004, p. 62); Page (2009); Romano (2004); Shapiro (2004) & Turnbull (2008b).

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[1] 'We were shocked and surprised that, even after the ship had run aground, so many of those that were on the bridge were still so keen to congratulate themselves on their collective navigational skills', (PCBS 2013).

[2] In referring to the role the auditor Lord Bridge stated: 'No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them' (Caparo 1990, p. 11).

Auditing by UK shareholders was first prescribed in the Company Clauses Act of 1846. The government paid a shareholder to act as the auditor and then invoiced the company to recover their cost (O'Connor 2004, p. 14). The UK audit cannot be for economic reasons as the law applies also to corporations without shares whose liabilities are limited by the guarantee of its members.

The UK 1862 Company Act published a model optional corporate constitution that established a *shareholder* audit committee as found in some European jurisdictions today[3]. At that time many companies were family controlled with family members on the board. So it is understandable why families with impeccable reputations like those of Sir Adrian Cadbury would consider it was not the directors that an external auditor needed 'to scrutinise' but just their managers like in the US.

However, company law requires directors to avoid conflicts of interest. As auditors are appointed to judge if the directors' accounts are true and fair, a toxic systemic unethical conflict of interest is created when those being judged control the judge. No law court judge could accept such a conflict. As pointed out by Shapiro (2004), those 'who pay the auditor call the tune'. As all directors are being judged it makes no difference if some are described as 'independent'.

However, accounting standards allow auditors to attest when they co-sign the directors' accounts that they are "independent". But if the ordinary meaning of the word "independent" were applied it would represent a lie. That audits are 'not independent at all' has been confirmed by a former big four UK audit partner (Hayward 2003). Bazerman, Morgan & Loewenstein (1997) have pointed out 'The impossibility of auditor independence'. O'Connor (2004: 62) states:

> Thus, the American accountant/auditor is placed in the untenable position of the agent serving many masters with conflicting interests. In such an imbroglio, is it any wonder that the group who hires, fires, and sets compensation for the auditor becomes the *de facto* client?

'Agents cannot successfully serve two principals with potentially adverse interests' (O'Connor 2004: 3). The purpose of having an audit is because of the possibility that the interests of directors are different from those of the shareholders as noted by Lord Bridge cited in footnote 2. Milgram (1974) first identified the general nature of this problem of 'good people' doing bad things, even like torture and genocide from peer group pressures.

The Sarbanes Oxley Act (SOX) makes legal directors having counterproductive conflicts in controlling the external auditors. SOX was described as 'Quack Corporate Governance' by Romano (2004) who stated:

> The learning of the literature, which was available when Congress was legislating, is that SOX's corporate governance provisions were ill-conceived. The political environment explains why Congress would enact legislation with such mismatched means and ends.

UK regulators have forced directors of UK banks and their auditors to accept this counterproductive unethical relationship. This is inconsistent with the ethical aims of the UK Financial Conduct Authority and Australian regulators.

3. Systemic director conflicts

Directors who form board nomination and remuneration committees also become exposed to the conflict of being involved directly or indirectly with their own nomination and remuneration. Describing some directors as "independent" does not remove the conflict of influence and loyalty to each other sitting around the same board table. It explains the unconscious bias reported by Page (2009). Dallas (1988) explained how boards form 'power coalitions' and the systemic conflicts of directors (Dallas 1997).

[3] An arrangement proposed for Australia by Senator Murray (1988) and for the UK by Hatherly (1995).

So-called "independent" NEDs have also been shown to be impotent from preventing expropriation of value from the company in a number of corporate failures (Coffee 2005). Bhagat and Black (2002) found no correlation between board independence and long-term firm performance with Swan & Forsberg (2014) reporting that independent directors 'destroy corporate value'.

The findings of Swan and Forsberg are consistent with Bhagat and Black (2002) who reported: 'We find evidence that low-profitability firms increase the independence of their boards of directors'. One reason is that CEOs promote board renewals so there is a loss of board memory of CEO shortcomings. Clarke (2006) pointed out the lack of both theory and empirical evidence supporting the appointment of non-management directors to boards and audit committees, while Rodrigues (2007) noted: 'The fetishization of independence'.

It would seem that governments and their regulators have been captured by the corporate governance industry. Governments have exacerbated this problem by appointing industry experts to advise them. In addition governments are subjected to the lobbying of professional bodies that represent the interest of practitioners. Directors and rating agencies find the research and analysis of scholars inconvenient in promoting their power, status, influence and income.

The conduct of Annual General Meetings (AGMs) is another example of the ubiquitous mindless blindness of regulators and directors to unethical behavior. Unethical conflicts arise when a director chairs an AGM. This is because the purpose of holding an AGM is for directors to present their accounts to shareholders and become accountable to them. However, shareholders may find it difficult if not impossible to hold directors to account if a director controls the meeting. The chair has the power to control which shareholder can speak and for how long. Corporate constitutions may specify that the chair of directors chair shareholder meetings. This demonstrates how stock exchanges and regulators who seek to promote ethical standards have accepted unethical practices.

If regulators or directors wanted to be seen to act ethically and remove the above-mentioned systemic conflicts of interests they would require PTC to amend corporate constitutions. One approach would be for shareholders to elect two boards as suggested by Tricker (1980) and Dallas (1988; 1997) or as practiced in a number of non-English speaking firms around the world surveyed by Turnbull (2000c, p. 141-173).

A basic approach for shareholders to consider in introducing two boards to create a constructive division of powers is illustrated in Figure 1. One board is to manage the business and the other to govern the corporation. This separation of powers is commonly introduced as a condition for providing finance by venture capitalists and bankers. It eliminates directors having absolute power to identify and manage their own conflicts of interest. It removes the power of directors to corrupt themselves and the business absolutely. It also provides a creditable basis for managing any residual conflicts that may arise from non-systemic operational conflicts arising from related party transactions.

While a European supervisory board separates some governance powers from those of management the conflicts remain because the management board is accountable to the governing supervisory board rather than being separately elected and accountable to shareholders. When shareholders appoint both boards different voting methods can be introduced to protect minority interests as well as provide additional checks and balances on power coalitions.

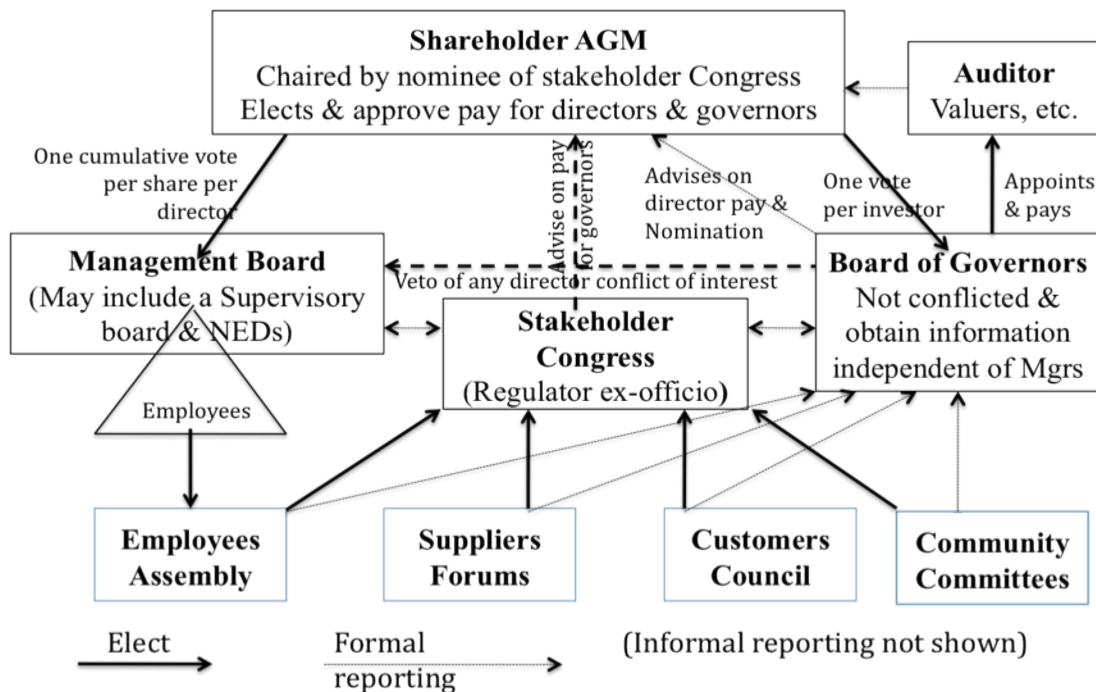
To protect minority shareholders in an Australian start up company I founded, I introduced cumulative voting to elect directors and one vote per investor to elect governors (Turnbull

2000a). Cumulative voting allowed our US investors to appoint up to 20% of the directors. Instead of being an impotent minority they could privately inform the governance board to exercise its veto power for any unauthorized board conflicts or other irregularities. This provided sufficient comfort for US investors to contribute funds to a company controlled by Australians!

If minority shareholders had controlled the statutory audit board of Parmalat, its accounting fraud might well have been discovered before the company became bankrupt in 2003. The fraud was not prevented because the CEO was a major shareholder who controlled both the audit board and the supervisory board (Melis 2004).

Figure 1 : Generic illustration of network governance

Separation of governance powers from management allows independent bottom-up and outside-in stakeholder intelligence to integrate governance into CSR management



Corporate Governance is fundamentally about power. Corporate constitutions create a contract between shareholders and directors to specify how corporate power is organized. Regulators are irresponsible in allowing directors to obtain absolute power to corrupt themselves, their business and so the well being of stakeholders. Regulator irresponsibility is especially egregious with banks that can put the financial system and the real economy at risk.

Most crucially, regulators, governance experts, practitioners and many academics are in denial that Anglo governance practices are unethical and counter productive. Yet as noted earlier a 'key cause' of the 2008 financial crisis was a 'dramatic failure of corporate governance'. Such 'dramatic failures' did not arise because financial institutions did not comply with what is thought to be best practice but because they did. There are many other examples like Enron, Lehman and UK Banks failing with so-called "good" governance.

Rather than admit that current governance codes and practices are unethically conflicted, regulators, practitioners and some academics are blaming the culture of individuals. Regulators have now obtained powers to regulate the illusive concept of culture by requiring

directors to be "fit and proper persons". However, it is the culture of regulators that is the principle problem. It has created collective mindless blindness to recognising the unethical conflicted self-serving relationships in the firms they regulate.

Culture of firms being regulated is only a second order problem. The first order problem is to change corporate constitutions to remove systemic toxic conflicts of interest. This would lead the way for establishing more efficient, productive, self-governing and sustainable firms. It would also reduce the cost of regulation and enrich democracy (Turnbull 2013). A basis would be established for introducing "Good Governance" as is next considered.

4. Defining good governance and its competitive advantages

A simply way to define good governance for any type of private, public or non-profit organization is: "Do no harm and act ethically". In the 18th century US charters of firms that did harm were cancelled (Grossman & Adams 1993). This was at a time when charters were only given for twenty years or less. The benefit of recapitalizing firms on a regular basis with "Time Limited Corporations" (Turnbull 1973) is to systematise 'creative destruction' (Schumpeter 1976). An important result is that it makes executives continuously accountable to their investors[4]. Among other advantages it makes capital markets more efficient (Turnbull 2000b).

The above simple definition of good governance can be expanded to provide guidelines on how to design the governance architecture of organizations. The requirement 'to do no harm' requires the organisation not to incur costs for taxpayers in their regulation. These costs arise from the need for governments to establish laws, regulations, regulators and a legal system to protect citizens from harms and risks that organisations may introduce.

Good governance then depends upon organizations maximizing their ability to become self-governing (Turnbull 2014a) while imposing no costs, harms of risks on society while acting ethically and equitably in furthering the reason for their existence. To achieve this objective the governance architecture of organizations needs be designed to engage with any citizen who could be harmed or put at risk by its activities. As more organizations adopted good governance the cost and size of government would be reduced. More and more citizens would be able to become engaged in the governance of organisations that may affect them. Good governance would enrich democracy while protecting and furthering the interests of citizens.

The proliferation and continual failure of corporate governance laws, regulations, regulators and codes of practice, as discussed above, provides evidence that current practices are not achieving good governance. Good governance requires citizens who may be exposed to harms and risks to be included in the governance of the organisation. Citizens then obtain the incentive to provide feedback to inform directors and their managers of not only their concerns but also to provide business intelligence for obtaining operating advantages. For example researchers have discovered that in some industries around 90% of innovations are obtained from customers rather than the Research & Development unit of a firm (Hippel 1994).

In addition, the involvement of stakeholders in the governance of firms can provide directors and other monitors such as governors included in Figure 1 with feedback information, independent of management, to cross check information provided by management. Without such independent feedback directors cannot possess a creditable way to carry out their

[4] Limited life enterprises compel firms to continuously distribute all profits and grow through dividend reinvestment in successor "offspring" firms. This transfers the re-investment decision from executives to shareholders and the wider economy.

fundamental fiduciary duty to monitor executives on a systematic basis. Without stakeholder feedback firms may not become aware if they are doing 'harm'.

However, it may not be in the interest of employees alone to report negative community impacts of the business, especially if they could be held responsible and/or it could diminish their ability to further their careers. Wider stakeholder engagement in corporate governance becomes essential for firms to achieve good governance. Importantly it also provides a way to integrate Corporate Social Responsibility (CSR) into corporate governance (Turnbull 2014b).

However, it makes no sense to include stakeholders on a management board of a firm. A board accountable to everyone becomes accountable to no one. It was for this reason that the advice of Porter (1992; p. 17) was ignored when he recommended that US corporations should: 'Nominate significant owners, customers, suppliers, employees, and community representatives to the board of directors'. However, the Porter analysis provides compelling evidence for corporate charters to formally include operational stakeholders in the governance architecture of firms to obtain competitive advantages. How this might be constructively achieved is illustrated in Figure 1. The firms cited in the introduction that possessed hundreds of boards indicates the legal possibility of introducing a division of powers with multiple boards that can also facilitate diverse types of stakeholder participation. Their existence also provides evidence of the competitive advantages of network governance over generations of managers. Instead of complicating the role of executives and requiring more executive time coordinating the various decision-making centers, the opposite occurs. While the governance architecture is more complicated the counter-intuitive outcome is that it can allow the role of each executive to be greatly simplified. This is illustrated by comparing the data processing load of directors of a firm governed by a single board with one governed by a network of boards as summarized in Figure 2 reproduced from Turnbull (2000c: Figure 3). Another example is Visa International Inc. created with hundreds of boards within the one business entity. The founding CEO Dee Hock (1999, p. 181) explained: 'No part knew the whole, the whole did not know all the parts, and none had any need to know'.

Figure 2: Mondragón compound board compared with unitary board

(Degrees of decomposition of information processing labour indicated by allocations of "X")

Board type	**Mondragón compound board**					**Anglo**
Control centers[a]	Watchdog Council	Supervisory Board	Mgr. Board	Social Council	Work Unit	Unitary Board
Members	3	5-8	4-6	~5-25	~10-20	~4-12
Function[b]	Governance processes	Appoint Mgt. board	Organise operations	Worker welfare	Production, Elec.Soc.C.	Manage
Activities	Efficacy & integrity of processes	Integrate strategic stakeholders	Efficient resource allocation	Establish working conditions	Job organ-isation & evaluation	Direct & control
Internal[b]	X		X	X	X	XXXX
External[b]	X	X				XX
Short term[b]	X		X		X	XXX
Long term[b]		X		X		XX

[a]Omits the General Assembly, which elects Watchdog Council and Supervisory board.
[b]Descriptions follow typology of Tricker (1994, p. 244 & 287)

The degree of simplification introduced by a Mondragón compound board is indicated by the how "Xs" are processed in each component. Components of a Mondragón board only have two or three Xs while a unitary board eleven. The simplification in increased by different individuals being involved in each component of a Mondragón board with all workers being included.

Distributed or "Network Governance" not only reduces information overload on directors and executives but introduces sources of intelligence independently of management to monitor management. Stakeholders can provide feedback on the Strengths, Weaknesses, Opportunities and Strengths (SWOT) of both management and the business. Stakeholders can be expected to have views that are contrary to those of management. In this way directors can not only cross check management reports on the known knowns but also obtain different views on the known unknowns and expose themselves to becoming aware of the unknown unknowns. This is not possible in command and control hierarchies where contrary behavior or views may not be tolerated.

In network governed firms like the UK employee controlled John Lewis Partnership (JLP), contrary views are encouraged. The JLP constitution and rules enshrine complex bottom up feedback with checks and balances. For example, they include the right of any employee to publish criticism of managers anonymously in a weekly *Chronicles* published at branch levels by head office. The JLP constitution states: "the happiness of its members' is the Partnership's ultimate purpose"[5]. JLP goes on to state our "Principles and Rules enables us over the long term to outperform companies with conventional ownership structures". Independent analysts have confirmed this statement for both JLP and the network-governed worker owned MCC in Spain (Turnbull 2000c, pp. 199-225).

There are wide variations in the control and communication architecture of network-governed firms. The architecture of each firm needs to be designed to not only recognise the limited ability of humans to receive, process, store and share data, information, knowledge and wisdom but to provide operating advantages. Without a division of powers and checks and balances introduced by network governance as suggested in Figure 1 it is not possible to achieve good governance.

It is not corporate law that denies good governance but corporate governance codes, principles and regulators. The UK Financial Conduct Authority web page states that it requires firms to act ethically but it accepts the systemic toxic unethical conflicts as described above. Australian Prudential Regulatory Authority (APRA), like The UK Prudential Regulatory Authority and the Sarbanes Oxley Act prescribes the adoption of toxic conflicted relationships that ethical directors and auditors would want to avoid. The time is long overdue for Parliaments to hold their regulators to account for accepting and promoting counter productive unethical governance practices.

The mind-set and remit of regulators need to be radically changed. Instead of regulators making rules and enforcing compliance, they should require firms and their shareholders to make the rules and enforce compliance to "do no harm and act ethically" in furthering their business interests. This would require shareholders to adopt corporate constitutions that promoted self-regulation, self-governance and so good governance. The impossibility of any regulator or CEO to directly control complexity is revealed by the science of governance grounded in the laws of nature.

5. The natural laws of governance

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[5] Refer to: http://www.johnlewispartnership.co.uk/about/our-constitution.html, viewed 10 February 2015.

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The natural science of governance reveals that it is impossible to regulate complexity *directly*. The science of governance is grounded in "the science of control and communications in the animal and machine" identified less than 80 years ago by Wiener (1948). Transaction Byte Analysis (TBA) has extended the science of cybernetics to social organisations by adopting bytes as the unit of analysis (Turnbull 2000c). In this way the ability of social animals to understand, communicate and survive in dynamic, complex unknowable environments can be analysed using the same unit of analysis for evaluating computers and the internet.

Governance science explains why the human brain has 'no Chief Executive Officer neuron' (Kurzweil 1999, p. 84). Instead different parts of the brain become responsible for making different types of decisions. This is what occurs in the network-governed organisations such as VISA, JLP and the MCC. The science of governance also explains how small creatures with simple brains obtain reliable ability to survive and reproduce in dynamic complex unknowable environments when organisations managed by highly educated humans with far superior brains may not.

The limited ability of human physiology and neurology to transact bytes can now be measured as reported in Turnbull (2000c: Table 3.5). This provides criteria for designing organisations so as to avoid humans being subjected to data overload in their communications, data processing and storage. Organisations can now be designed like computers so that the data processing capacity of human communication and control channels are not exceeded.

To avoid data overload organisations involved with complexity need to decompose communications, decision making labour and control into simpler elements by introducing distributed communication, decision-making and control networks. The most common strategy for decomposing decision-making is to form centrally controlled command and control hierarchies. But power hierarchies posses fundamental flaws as identified by Liebenstein (1987), Downs (1967: 116-8). A crucial advantage of network governance is not that it just introduces distributed intelligence but that it also creates the capacity to introduce requisite variety of feedback signals and control channels to manage complexity as reliably as required. The importance of obtaining a 'requisite variety' of channels to control (Ashby 1968, p. 202) and communicate (Shannon 1948) accurately has been established mathematically.

Ashby's law of requisite variety states that complexity can only be regulated *indirectly* through supplementary co-regulators (Ashby 1968, p. 265). It is the stakeholders and citizens who governments make laws to protect that are required to be involved as co-regulators to provide a requisite variety of both control and communication channels. Network governance creates the ability to constructively engage with stakeholders to provide mutual benefits.

The inclusion of stakeholders in the governance architecture of firms and their regulators can provide many benefits for shareholders, directors, auditors, managers, stakeholders, regulators and civil society, as set out in Turnbull (2014b). Some of the general advantages are:

(1) It is a condition precedent for directors to be able to creditably monitor management independently of management on a systemic basis;
(2) It is a condition precedent for firms to reliably and comprehensively obtain access to intelligence about the complexity of their operating environments;
(3) It is a condition precedent for reliably controlling complexity;
(4) It is a condition precedent for improving self-regulation, self-governance and so good governance;
(5) It creates a basis for cross checking management information of the known knowns;
(6) It provides a check if management are aware of all the known unknowns;

(7) It improves risk management and identification of new opportunities arising from what would otherwise be unknown unknowns;
(8) It simplifies public corporate social and environmental reporting by either the firm or its stakeholders as these issues can be privately reported and resolved directly with the citizens concerned;
(9) It removes the need to comply with CSR reporting standards as the citizens requiring the information either generate it and/or obtain it privately on a continuous basis to expedite amelioration and correction;
(10) It reduces the size and cost of government to enrich the quality of democracy.

Table 1: Summarising advantages of network governance for NEDs

Systemic problems for Non-Executive Directors (NEDs) on a unitary board:		Systemic solutions from introducing network governance used by nature. Also described as "ecological governance"
1	Suspicion by outsiders that the absolute power of directors to identify and manage their own conflicts of interest might corrupt the directors and/or the business.	Corporate charter establishes a governance board and a management board of directors elected by cumulative voting with one vote per share and Governors with one vote per shareholder. Governors control internal and external auditors, director nomination and pay with veto powers when conflicts exist for directors (Dallas 1997).
2	No creditable systematic process for NEDs to determine when their trust in management might be misplaced.	Corporate charters makes provision for any class of stakeholders to elect a representative board to meet with governors independently of management or directors to provide feedback and/or feed forward competitive intelligence to them and/or managers.
3	Exposure of NEDs to personal liabilities and loss of reputation from management misdeeds.	Misdeeds of executives are the responsibility of the directors' as Governors do not have power to manage business operations. As indicated in Figure 1 directors could include non-executives.
4	No systemic access for NEDs to information opposing management views and so for evaluating management independently of managers.	Feedback from establishment of one or more "Employee Assemblies", "Creditors Councils" and "Debtors Forums" who may appoint a "Stakeholder Congress" to advise on KPIs used to determine executive appointments and their remuneration.
5	No diversity of information sources to cross check integrity of management information or obtain second or more opinions.	Diversified feedback provided from specialized stakeholders groups and their Boards with informal access to Government regulator who chairs their Stakeholder Congress. Congress manages AGM that determines the pay and election of Directors and Governors.
6	Coping with data and information overload.	Compliance information and liabilities transferred to directors with option of strategic analysis transferred to a supervisory board as found in Europe.
7	Difficulties in detecting biases, errors and omissions in reports from managers.	Access to a requisite variety of independent crosschecking sources of stakeholder feedback to obtain accuracy as much as desired as demonstrated by Shannon (1948).
8	Inadequate knowledge for complex decision-making.	Simplification of decision-making (Von Neumann 1947).
9	Board decision-making subject biases in its membership – Gender biases, etc.	Exposed to multiple diverse and contrary viewpoints raised by stakeholders to force consideration of taboo topics and avoid culture of don't ask don't tell.
10	Lack of will to act against management.	Governors not captive to management information and/or executive powers and influence with independent power and/or influence on director nomination, pay and tenure.
11	Lack of a systemic way to safely blow the whistle on errors, misdeeds, etc.	Provided privately by network of boards connected to the government regulator and/or firm specific employee ombudsperson.
12	Impossibility of *directly* controlling/countering complex variables/risks.	Control amplified *indirectly* through requisite variety of stakeholders acting as co-regulators (Ashby 1968, p. 265).

The Table 1 assumes that NEDs have vacated the management board to take up the role of Governors. Advantages of network governance for auditors, management, stakeholders (other than shareholders), regulators and shareholders are detailed in Turnbull (2013; 2014b).

6. Concluding remarks

The discussion above indicates some of the win-win advantages of network governance for corporations, their stakeholders, regulators, government and society. The existing system of Anglophone governance is conflicted, unethical, and counter-productive for all types of organizations. The imposition of this defective form of governance on financial institutions by so-called prudential regulators is not just unacceptable but dangerous for the health of national economies.

Many commentators are concerned about the stability of the financial system. Some expect that the next crisis could be more severe. Governments have not learnt the lessons of history such as documented by the US Financial Inquiry Report and the concerns of many other commentators. Since the 2008 financial crisis significant improvements have been made in improving the equity and liquidity buffers of the banking system. This is has been initiated by economists and bankers who apparently do apply their common sense to understand how unreliable and toxic is current system of governance. The current situation again demonstrates how good people can do bad things by peer group pressure (Milgram 1974).

No less than parliamentary inquiry is required to provide intellectual leadership and confidence for regulators to change their approach. This could also force the vested interest of practitioners and their professional bodies to open their eyes to their mindless blindness to unethical practices. As noted above there is considerable power and influential vested interests in promoting or defending the current unconscionable unethical counter productive system of governance. Urgency is required because many commentators are anticipating another financial crisis.

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